Kopion Asset Management

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Endurance Riding

Great works are performed not by great strength, but by perseverance.

-Samuel Johnson

Wednesday, January 13, 2016

Dear Kopion Clients,

Kopion finished 2015 down 17.5% before fees (-18.2% after fees). This compared to the S&P 500 and Russell 2000, which returned 1.4% and -4.4%, respectively. Our poor showing was primarily due to a continuation of the trends that I discussed in my 3rd quarter letter.

2015 was a grueling year for a wide range of stock pickers. I spoke with one analyst who lamented that we have been in a "stealth bear market" for small cap stocks. I have also heard anecdotally about other managers whose results have been similar to and in some cases worse than our own. Even value investing stars David Einhorn and Bill Ackman each reported 2015 losses of about 20%.[1] Some pundits are saying that stocks are expensive, but as I look at how we and others have performed and more importantly, the underlying values in our portfolio, I believe that the market is actually quite nervous and contains plenty of undervalued stocks. This wariness can also be seen in the growing cash balances at pension and mutual funds as those investors edge away from the stock market.[2] This anxiety has increased markedly during the first weeks of 2016, which can be particularly discouraging after we have already taken so many lumps in 2014 and 2015. The truth remains, however, that the market offers attractive long-term returns to investors who can endure the storm and stay the course.

I will return to the subject of perseverance later in this letter, but I first want to discuss three factors that have hurt our portfolio, which will also provide some context for 2016. These three factors are: 1) the strength of the U.S. dollar, 2) the price of crude oil, and 3) the Chinese economy. These are each broad, complicated subjects, and I am only going to touch upon the most critical points as they relate to our portfolio. In some

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[1] Stevenson, Alexandra and Matthew Goldstein, *Hedge Funds Struggle With Steep Losses and High Expectations*, The New York Times, December 28, 2015. See also: *Ackman Leads Hedge Fund Industry Losses* by Yoel Minkoff, January 6, 2016 at www.seekingalpha.com.)

[2] Martin, Timothy W. and Sarah Krouse, *Latest Fund Fashion: Cash*, The Wall Street Journal, January 11, 2016.

cases, I'm also going to generalize because it is not practical to go into greater details within the space of this letter.

THE STRENGTH OF THE US DOLLAR

Currency fluctuations of plus-or-minus 1-5% are a normal part of the "noise" in our companies' results. During 2015, however, the U.S. Dollar strengthened 16.1%,[3] which created a large headwind for many of our companies (and their stocks). According to the press and basic economic theory, a strong U.S. Dollar hurts domestic companies by making their goods less competitive with those of foreign firms. This is partly true, but it grossly oversimplifies the situation because many U.S. companies have factories in foreign countries, and they also buy components from foreign suppliers. The impact of foreign exchange rates thus varies from firm to firm. Most of our companies sell and produce their products around the world, but they all report their results in U.S. Dollars. As the U.S. Dollar has strengthened, the value of those foreign sales has translated into fewer U.S. dollars. One such example is BorgWarner. If foreign exchange rates had stayed constant during 2015, BorgWarner's revenues would have grown about 4.5%. That would be a slow year, but not a bad one. After factoring in the strength of the U.S. Dollar, however, BorgWarner's 2015 revenues are expected to decline about 6%, which is a bad year. Foreign exchange rates are generally unpredictable, but this headwind seems likely to greatly diminish in 2016, *which would allow our companies' underlying results to better show through.* It is also worth noting that many of the pundits who say the market is expensive base this partly upon U.S. companies' weak earnings growth during 2015. In my opinion, however, this apparent weakness has to be understood within the context of 2015's unusual currency headwind. Indeed, the U.S. Dollar could eventually weaken, and that would provide a tailwind for our companies' earnings.

LOW OIL PRICES

As I have discussed in previous client letters, Kopion's exposure to energy companies is not unduly high on an absolute basis, but it is much higher than the indices. The precipitous decline in oil prices has thus weighed heavily on our results during 2014 and 2015.

Oil prices have been acutely weak because of two large new sources of supply that developed over the last few years. The first is the U.S. shales, which underpinned a major increase in U.S. production. The second is Saudi Arabia. Historically, Saudi Arabia produced most, but not all of its available capacity. This allowed it to tweak its production up and down in order to manage the global supply of oil and thus oil's price. In the fall of 2014, however, Saudi Arabia decided to produce all of its known capacity in order to reclaim market share that it had lost to other producers, including the U.S. shales. Saudi Arabia's decision was likely also motivated by political considerations. For example, low oil prices have the added benefit of weakening Iran with whom Saudi is fighting a proxy war in Yemen. (Yemen borders Saudi Arabia on the south.)

In my opinion, however, neither of these sources of supply are sustainable. Oil wells naturally deplete every year, and shale wells deplete particularly quickly. Producers thus have to continue drilling new wells just to sustain production. Within the industry,

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[3] Source: U.S. Federal Reserve, Nominal Major Currencies Dollar Index.

this is referred to as the production “treadmill”—running just to stay in place. Very few oil companies can earn even a 10% return on their new wells if oil is $50.00 per barrel. Indeed, over half of the world’s oil production cannot be sustained at $50.00.[4] (Prices are currently about $30.00.) Low prices have thus led to dramatically lower investments in new wells, both in the U.S. and abroad. Lower U.S. investment began translating into lower production during the summer of 2015, and this trend seems likely to accelerate through 2016.

Saudi Arabia is harder to predict, but in my estimation, they have painted themselves into a corner. Global investment in new wells is dropping rapidly, which is sowing the seeds for lower future supplies and higher future prices. In the past, the Saudis have been able to constrain those types of price increases by adding supplies from their own excess capacity. Today, however, the Saudis seem to be producing all of their known capacity. This suggests that they have forfeited their ability to curb future price spikes, and that is a very poor position strategically. In addition, very low prices have forced oil companies to become much more efficient, which is also negative strategically for the Saudis. Lastly, low prices are making it harder for Saudi Arabia to subsidize their social programs. Game theory and fiscal necessity thus both auger for lower Saudi Arabian production in the future.

I therefore believe that it is only a matter of time until oil prices recover, and this should eventually buoy our energy stocks. One factor that will influence the timing of this rebound, however, is demand from the Chinese economy, which seems to have begun slowing in early 2015.

THE CHINESE ECONOMY

The Chinese economy is the world’s second largest after the U.S., and Kopion’s companies are affected by it directly and indirectly. Returning to BorgWarner, China represents roughly 13% of companywide revenue and about 32% of the new revenues that BorgWarner expects to gain over the next three years. The recent slowdown in the Chinese economy has thus had a direct impact on that part of BorgWarner’s business. China also has myriad indirect impacts on our companies. For example, China accounts for about 11% of global oil consumption and could thus influence the timing of the recovery in oil prices, as noted previously. From a high level, China’s deceleration during 2015 caused some of our companies to grow somewhat slower, though this impact varied across the portfolio.

China’s economy is incredibly opaque, so it is impossible to know how quickly it is slowing or all of the the reasons behind this change. Behind whatever type of transitions or disruptions that China might go through, however, are 1.3 billion people, many with low standards of living who are working towards a better life. This should result in continued economic growth over the long-term and thus provide direct and indirect opportunities for many of our companies.

[4] William R. Thomas, CEO of EOG Resources. *Volatile Oil Prices and U.S. Horizontal Shale Oil Opportunities and Challenges*, presented at Rice University on November 6, 2015.

Perseverance

In my opinion, a patient temperament that can endure and see clearly during hardship is one of the most important attributes that an investor can possess. In its simplest terms, such fortitude allows investors to avoid "selling at the bottom," but its implications are broad and extend well beyond investing. For example, history offers some extremely consequential examples of endurance such as William Wilberforce, Abraham Lincoln, and Winston Churchill. Investing offers its own role models in this area, and Hermes, the alumni magazine of Columbia Business School, profiled seven such investors in two articles during the mid-1980's.[5] The first of these articles is a well-known essay by Warren Buffett, and the second is a follow-on article that was published two years later. One of my mentors gave me a copy of the second article very early in my career. Back then, I was too inexperienced to fully appreciate its implications, but I now understand: stock investing is not like a 10K run or even a marathon. It is more like the endurance horseback riding competitions of the late 1800's, which reportedly covered hundreds of miles and lasted for many days. The two Hermes articles capture this long-distance nature of stock investing. All seven of the investors profiled in these articles generated phenomenal returns over the long run, but six of them also suffered through some very difficult seasons. In fact, those six investors lagged the market 28-42% of the time! The most extreme of these was Pacific Partners who badly underperformed the market for six consecutive years. Figure 1 shows the longer term performance of this firm as of the date of the first Hermes article. Figure 2 shows its results beginning in 1970, at the start of its losing streak. (In both figures, the years of underperformance are shaded in grey.) Note that in Figure 2, by the end of 1975, Pacific Partners was lagging the market by more than half! A better known example is Sequoia Fund, which began its history with a 3½ year losing streak and then suffered a second two-year period of

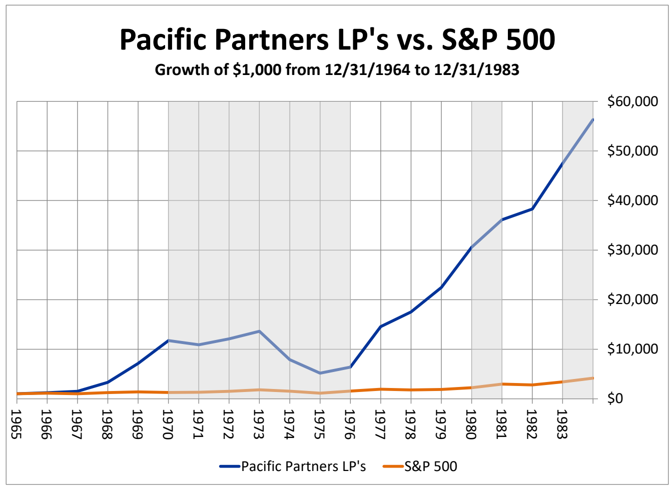

Figure 1

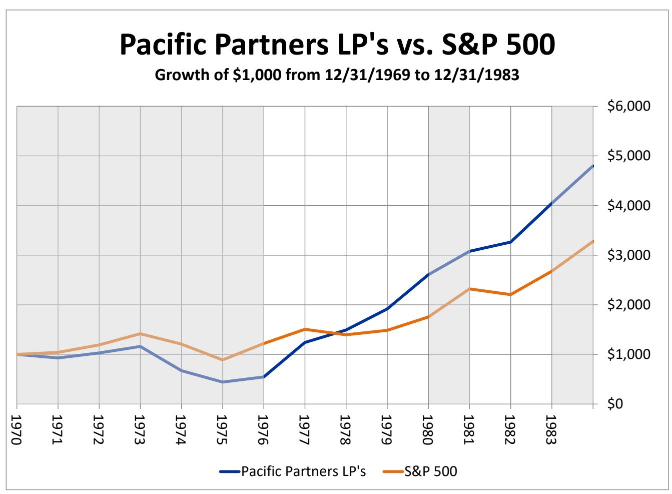

Figure 2

[5] Buffett, Warren E., *The Superinvestors of Graham-and-Doddsville,* Hermes, Fall 1984. Shahan, Eugene, *Are Short-Term Performance and Value Investing Mutually Exclusive? The Hare and the Tortoise Revisited*, Hermes, Spring 1986.

underperformance later in its history. Sequoia Fund's results are shown in Figure 3.

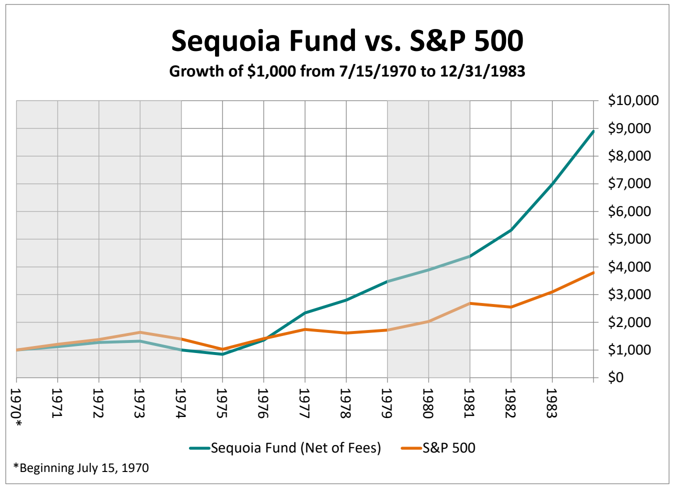

Figure 3

So while I am very disappointed with our results over the last two years, I recognize the lessons of the value investors and great men who have gone before us. I also find encouragement in the tremendous value-content that I see in our portfolio, and I am thus confident that the best decision is to stay the course and persevere through the present maelstrom.

Thank you for your patience, support and trust.

Best regards,

Terry Ledbetter, Jr., CFA

PERFORMANCE DISCLOSURES

Period	Kopion, Gross	Kopion, Net $_{\text{Max Fee}}$	S&P 500	Russell 2000
Annualized*				
1 Year	-17.5%	-18.5%	1.4%	-4.4%
3 Years	6.9%	5.5%	15.1%	11.7%
5 Years	7.5%	6.2%	12.6%	9.2%
Since Inception†	13.8%	12.5%	13.8%	12.6%

Period	T Ledbetter, Gross	T Ledbetter, Net $_{\text{Max Fee}}$	S&P 500	Russell 2000
Annualized*				
1 Year	-17.5%	-18.5%	1.4%	-4.4%
3 Years	6.9%	5.5%	15.1%	11.7%
5 Years	7.5%	6.2%	12.6%	9.2%
10 Years	10.1%	8.8%	7.3%	6.8%

*Ending 12-31-15
†Since 8-23-09

Past performance does not guarantee future results. Investments with Kopion may lose value.

Terry Ledbetter, Jr. began managing his first diversified investment account on 2-4-04 while employed by Friedberg Investment Management (FIM). Mr. Ledbetter left FIM on 7-31-09 and founded Kopion Asset Management, LLC (Kopion), which became a legal entity on 8-24-09. Importantly, when Mr. Ledbetter founded Kopion, he continued to manage the same accounts that he had been managing while employed by FIM. The accounts, investment strategy, and investment process all remained the same. The performance information cited throughout Kopion's marketing materials includes all of the diversified investment accounts managed directly by Mr. Ledbetter since 2-4-04, which is when he began managing his first diversified investment account. This information is provided for both Mr. Ledbetter's entire performance history as well as for the portion of Mr. Ledbetter's performance history that occurred after Kopion was founded and became a legal entity.

The performance information cited throughout Kopion's marketing materials has been thoroughly documented, and it has been calculated using normal industry protocols, which are described in more detail below. This information has not, however, been audited by an independent third party. Dividend and interest income in these accounts was reinvested. Returns for these accounts have been asset-weighted to calculate historical returns. Said another way, the accounts were aggregated into a single group and then performance was calculated for that single group. This group includes some sub-accounts and securities that were carved out of larger accounts in order to exclude assets like mutual funds that Mr. Ledbetter did not manage directly. Those mutual funds were managed by professionals at third party firms, and Mr. Ledbetter's involvement was limited to being a passive shareholder of those mutual funds. In addition, some of those mutual funds followed fixed income strategies, which were very different from the strategy used by Mr. Ledbetter when he was employed by FIM and later at Kopion. Performance information that includes assets like mutual funds that were not managed directly is available, and Kopion will provide it promptly upon request.

Kopion reports its Time Weighted Returns (TWRs). TWRs make adjustments for deposits and withdrawals so that those transactions do not influence performance results. Consequently, deposits do not increase the return, and withdrawals do not decrease the return. TWRs thus allow for performance comparisons between Kopion's (and Mr. Ledbetter's) history and market indices.

Kopion reports both "gross returns" (which are returns before Kopion's management fee) and "net returns" (which are returns after deducting Kopion's management fee). Kopion's management fee schedule is graduated, which means that the fee rate begins to decrease after an account's dollar value exceeds a certain threshold. The label "Net $_{\text{Max Fee}}$" indicates that the net returns being presented reflect Kopion's maximum fee rate for all periods presented. The words "net" or "after fees" without the words "Max Fee" in subscript lettering indicates that the net returns being discussed reflects actual fees.

Kopion has provided the returns of the S&P 500 and the Russell 2000 indices in order to provide the broader stock market context of Kopion's (and Mr. Ledbetter's) returns. The S&P 500 tracks the performance of relatively large publicly traded companies, and the Russell 2000 tracks the performance of relatively small ones. Kopion does not "benchmark" its portfolio against indices in the traditional sense of carefully managing the portfolio for comparison against a specific index. Instead, these two indices are used as broad indicators of the stock market's performance. Mr. Ledbetter has primarily focused on small and medium sized firms, but he has also invested in some large companies as well. This is why Kopion has provided the results of both the S&P 500 and Russell 2000. These indices cannot be invested in directly, but mutual funds and exchange-traded funds that track these indices ("index funds") are available in the market. Kopion's (and Mr. Ledbetter's) investment strategy carries more risk than investing in an index fund that tracks either the S&P 500 or the Russell 2000. This is primarily because Kopion's (and Mr. Ledbetter's) strategy involves investing in a relatively small number of stocks and those stocks are primarily for small to medium sized companies. This approach results in greater volatility and greater risk of capital loss than index funds tracking either the S&P 500 or the Russell 2000.

Indices' performance figures have been obtained from sources believed to be reliable.